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FOMC Briefing
February 3, 1981

Since the December 19 meeting of the FOMC the dollar has advanced sharply against the German Mark and the currencies linked directly and indirectly to the mark. This morning, the dollar mark rate hit 2.16, the highest in nearly 3 years, up 9-1/2 percent from the level at the time of the last meeting. Profit taking has brought the rate back to about the 2.12-1/2 level, but for the moment few would consider this a reversal of the recent trend in favor of the dollar. Although the dollar is on balance down or little changed for the period against the pound sterling, Japanese yen, and Canadian dollar, the declines were early in the period and the dollar's recent strength has shown through against these currencies.

The main reason for the dollar's strength continues to be favorable interest differentials. U.S. interest rates have in fact slipped back from their peaks in mid-December, but few exchange market participants expect a replay of the sharp drop in rates that occurred last spring. They cite the evidence that the underlying economy has been stronger than expected; they note the strong statements of resolve by Chairman Volcker and other Federal Reserve policymakers on the need to fight inflation; and they have responded to the warnings by several money market gurus that higher interest rates are yet to come. For the near term anyway, corporate treasuries and money managers who are active in foreign exchange markets expect that U.S. interest rates will remain relatively high by historical standards, and well above rates in most other major countries.

A second element of strength for the dollar over the past few weeks has been the very positive response to the statements of intent by the economic policymakers within the Reagan Administration, especially the President himself and Treasury Secretary Regan. There is still considerable skepticism in the exchange market that a tax cut cum expenditure cuts will lead to an elimination of the fiscal deficit, and indeed forecasts of a larger fiscal deficit to come are among the reasons why money market gurus are warning that interest rates may shoot upwards once again. But the exchange market has been heartened by the belief that the new Administration means business about tightening up on fiscal policy and about dealing with inflation. It's mainly a matter of market psychology. Some market people have used the term euphoria in describing this response.

By contrast, and this is the other side of the coin of the dollar's strength, the German authorities are in the defensive, talking about the things they are not going to do and can't do to resolve their current problems. The problems are serious—a flat economy if not an economy in recession, rising unemployment, a continuing massive current account deficit, a currency which is declining under heavy selling pressure not only against the dollar but also against other major European currencies, and now an ominous upcreep of wholesale and consumer prices. Adverse terms of trade, J-curve, and vicious circle elements have come into play, also for the first time really since the early postwar period. The Bundesbank is caught in the middle. It has held a firm monetary policy despite heavy political and academic pressures to stimulate the domestic economy and to neglect the inflation rate and external value of the D-mark for the time being. But

it has not taken the overt steps toward tightening policy that would satisfy those, from the other side of the policy debate, who believe that a low inflation rate and a strong D-mark should be the first priority to the neglect of growth and employment. The market has sensed this ambivalence by the Bundesbank and has become exceedingly bearish toward the D-mark. Again, it is largely a matter of market psychology—which can change—but for the time being it has propelled funds out of marks and into dollars.

In our operations, we have continued to amass D-marks although not as vigorously as we did when we were still covering our debts. Overall we purchased some \$1,573 million equivalent of marks during the period, as against some \$87 million of sales of marks when the dollar was slipping off in a thin market toward year-end. System balances in DM increased by some \$750 million to \$2182 million. This leaves the Desk with a leeway of some \$300 million under the \$2.5 billion limit set on our mark balances at the last FOMC meeting. The Treasury added a similar amount to its balances and it now holds some \$1.2 billion of marks beyond what it needs as cover to the Carter notes. In other operations during the period, we sold \$50 million of Japanese yen on one day early in January, when that market was particularly disturbed and the dollar was generally on offer. We also bought \$20 million of Swiss francs last week for balances, shared with the Treasury.

Finally, the Swedish Riksbank drew \$200 million under the swap line with U.S. The Krona had been under heavy selling pressure, leading to unexpectedly large dollar sales. Monetary policy measures have been taken and a fiscal package is hopefully in the offing. The drawing is a bridge financing toward a jumbo loan of \$1 billion being

negotiated by the Swedish government in the Euro-markets. The market has turned around yesterday and today and the Riksbank has bought dollars, so the immediate pressure is off. We will, of course, be following this situation closely.

Notes for FOMC Meeting
February 2-3, 1981
Peter D. Sternlight

After several months in which monetary growth exceeded the Committee's objectives, the December-January performance presented a marked change. December showed a substantial rate of decline in the narrow aggregates and only modest growth in the broader measures. January data, though subject to uncertainties of interpretation due to the massive shift into NOW accounts, seem to show a resumption of fairly robust growth in the narrow measures, but combined December-January growth remained below path. As a result of below-path monetary growth, demand for reserves tended to fall somewhat short of path levels. The shortfall in total reserves was about \$100 million for the first four weeks of the seven-week interval, while in the final three-week subperiod, which ends tomorrow, it's estimated that total reserves could average about \$400 million below path.

The usual and expected accompaniment of below-path growth in the aggregates would be a decline in borrowings and softening of the money market. Several factors worked to delay this result, however, leading to funds trading largely in a range of 19-20 percent over much of the period—thus maintaining the lofty level reached in mid-December before the aggregates weakened. In the closing weeks of December, borrowing ran somewhat higher than intended and the federal funds rate also tended to exceed expected levels, possibly due to sustained high demands for excess reserves. The reserve paths allowed for somewhat higher than normal excess reserves but apparently the allowance was not sufficient at that point. After the turn of the year, borrowing fell off, for a time, to around the expected range but the funds rate remained high—in fact

averaging a snip over 20 percent in the first week of the year. Excess reserves continued to run above expectations, even though our expectations were progressively boosted. Pressure was also exerted on the funds rate by the heavy volume of dealer financing in early January, and bank preparations for large Iran-related payments around mid-month. Another persisting influence, probably, was the sheer inertia exerted by high rates in preceding days, bolstered by the markets' feeling that the System preferred rates in the area of 19 percent or somewhat higher. In the last week or so, the funds rate has slipped back from its predominantly 19-20 percent range to the area of 17-18 percent, oddly enough at the same time that discount window borrowing rose somewhat.

Desk operations during the seven-week period were complicated by large swings in the market factors and by uncertainties related to the Iranian payments settlement. Early in the interval, large and hard-to-predict changes in market factors called for large temporary injections and withdrawals of reserves. In mid-January the basic outlook called for reserve absorption in good part to counter seasonal reductions in required reserves and currency in circulation. But the money market was quite firm as banks prepared for the Iranian settlement. Against that background, when the Desk received instructions to sell \$1.1 billion in bills for the Iranian account late on January 16, the most feasible course was to buy these bills for the System, with a view to taking appropriate offsetting action later on. The System's purchase had, in fact, no immediate reserve impact since initially the proceeds went into the pool of foreign account short-term funds employed in day-to-day matched sale-purchase transactions with the System account. Subsequently, the purchase of bills from Iran was much more than offset

through sales of bills in the market and to foreign accounts, and run-offs of maturing bills. On a net basis, outright holdings of bills were reduced by \$3.8 billion over the period, thus using most of the additional leeway voted by the Committee on January 23.

Around the time of the December Committee meeting, the fixed income markets were in the midst of a big price rally, spurred by indications of slowing monetary growth and views that the economy might be weakening, perhaps because of the fourth quarter's sharp rise in interest rates. The conviction that the peak in rates had been seen gained momentum in the closing weeks of December, with more news of monetary weakness. Market participants noted the persistently high funds rate but were inclined to shrug it off as a temporary phenomenon related to year-end pressures. Investors were less convinced than dealers, however, and as the period progressed the rally faded and markets gave back part of the earlier gains. The persistently high funds rate and high dealer financing costs affected sentiment adversely, and these factors were reinforced by signs of some continuing economic growth, anticipations of substantial Treasury cash needs, and a sense that the Fed might resist large rate declines even if monetary growth abated. Lower funds rates late in the period provided fresh encouragement to the market but indications of big Treasury needs worked in the opposite direction at nearly the same time. On balance over the period, rates declined fairly substantially at the short end—as much as 2 or 3 percentage points on some instruments—and more modestly for intermediate and longer issues.

Three- and six-month bills were auctioned yesterday at 14.66 and 13.74 percent, compared with 16.67 and 15.42 percent shortly before the December meeting.

The decline is more noteworthy since the Treasury added steadily to new market supplies during the period while the System was also a big net seller. Yields on intermediate-term coupon issues declined about 50 to 150 basis points over the period while long Treasury maturities were down about 25 to 50 basis points. The Treasury also added substantially to supplies of coupon securities during the period—by some \$8 billion, not counting the net \$3-1/2 billion they are picking up in the mid-February refunding for which the first auction is being held today. They announced last Wednesday that total new money needs in the first quarter of 1981 would be a mountainous \$36 billion—a new quarterly record by far.

Elsewhere in the capital markets, there is reported to be a very large supply of intermediate- or long-term corporate issues poised for marketing if rates should dip somewhat lower.

In generally, one gets the sense that the markets would like to do better—especially participants would like to believe in the new Administration's confidence that productivity will improve, budgets will move toward balance, and inflation will work lower. At the same time there is considerable skepticism about whether this will really work as hoped for, and there is particular apprehension that large tax cuts may precede effective restraint on spending.

FOMC Briefing
S. H. Axilrod
February 2, 1981

The experience with NOW accounts in the early weeks of this year has certainly verified, indeed in that period magnified, that there are problems of interpreting M-1A and M-1B for policy purposes during the transition to nationwide NOW accounts. Measurement of the effective growth of these variables, abstracting from NOW account shifts, from actual data that reflect shifts is highly sensitive to the amount of shift and to the proportion of the shifted funds coming from demand deposits or other assets.

We can be reasonably certain about the amount of shifts. Since the trend growth in NOW accounts is relatively small in magnitude, virtually all of the change in interest-bearing checkable accounts (OCD accounts) can be said to reflect shifts related to introduction of NOW accounts nationwide. However, we are necessarily less certain about the fraction of these funds coming from demand or other accounts. And the adjustment to observed growth needed to obtain the effective growth that is significant for policy purposes is quite sensitive to these shift percentages. For instance, on the assumption that about $1/5$ of the new OCD accounts came from other interest-bearing assets, M-1B growth in January was about $6\frac{1}{2}$ percent at an annual rate; however, if it is assumed that $1/3$ of the funds came from these other assets effective growth in M-1B would be close to zero. Our information for January suggests that $1/5$ is closer to the right fraction (it might even be a bit low), but we do expect that fraction to rise as the shifts of large demand deposit accounts to NOW accounts become relatively less important. Shifts of large accounts appear to have been a major influence in the very early weeks of the year.

It should be pointed out, though, that the extent to which uncertainty about the fraction of NOW account funds coming out of demand deposits or other assets affects interpretation of the basic behavior of M-1 should diminish markedly over the months ahead. We may remain uncertain about the fraction, but as the total amount of shifting declines--and it looks as if it will decline sharply from the January pace--the significance of differences in the fraction will diminish. The actual behavior of the series will more closely approximate its effective growth; this will be more true of M-1B than M-1A of course so long as shifts into NOWs are mainly out of demand deposits.

Nonetheless, it may be tempting from recent experience to conclude that more emphasis should be placed on broader aggregates for operating purposes, at least temporarily, since they are not much affected by NOW account shifts. There is, of course, something to that argument. But there are risks in that direction also. The broader aggregates contain a mix of short- and long-term assets whose yields now vary to a great extent with market interest rates and thus whose amounts are difficult to control by monetary policy actions that affect market rates. In those circumstances, most of the adjustments to overshoots or undershoots of the broad aggregates would be thrown on demand deposits, and--because of the inelasticity of demand for such deposits--there would be enhanced risk of more interest rate volatility in the short run.

Looking to policy operations over the next few weeks, if credence is given to the view that there are limits in the degree to which the broader aggregates can serve as an effective basis for day-to-day reserve management, and given that uncertainties in interpreting the narrow monetary aggregates will still be large, the Committee may wish to consider establishing

a narrower funds rate range than even the 5 percentage point band of the last meeting. Such a narrower band would have the practical effect of permitting the Committee to judge the import of incoming evidence on both the broad and narrow aggregates before very substantial changes in credit market conditions are permitted to occur.

Whatever decision the Committee makes about the funds rate band, the speed with which outer limits of the band might be attained will depend in part on the particular path set for the monetary aggregates (with its associated reserve path). Alternative A hits the longer-run path midpoint for M-1B by March, but it implies relatively strong effective, and also actual, growth of M-1B in February and March that might raise questions about the System's commitment to lowering money growth--an issue that may be particularly sensitive in this period when the market will be closely assessing the interaction of fiscal and monetary policies. The alternative A path is also the path that is most likely to lead to a sharp drop of interest rates should the economy prove weaker than projected.

Alternatives B and C would not imply growth in M-1B by March to hit the midpoint of the FOMC's effective longer-run target for that aggregate--with the growth rate of alternative C keeping the narrow aggregates below the FOMC's longer-run range over the first quarter, given the December shortfall. This modest growth in M-1B of alternative C would, in contrast to alternative B, imply a substantial acceleration of growth from March to June should the Committee wish to hit the midpoint of its M-1B path by mid-year and might therefore also imply substantial downward interest rate pressures at that time should the economy be weakening as projected. This is not necessarily an argument against alternative C, of course. Rather,

it might suggest, for instance, that if the Committee takes the alternative C approach at this time, it might also be willing to contemplate a slower move back to the midpoint of its longer-run M-1B path over the course of this year (not getting back by June in other words) as a reasonable strategy in view of the importance of reducing inflationary psychology, or as more consistent with constraining growth in M-2 and M-3.